



University of Baltimore Law Review

Volume 3
Issue 2 Spring 1974

Article 2

1974

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Small Business Administration

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Recommended Citation

Weinmann, Eric (1974) "Venture Capital for Small Business," *University of Baltimore Law Review*: Vol. 3: Iss. 2, Article 2.
Available at: <http://scholarworks.law.ubalt.edu/ubl/vol3/iss2/2>

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VENTURE CAPITAL FOR SMALL BUSINESS*

Eric Weinmann†

To close the "equity gap" for small business, Congress enacted the Small Business Investment Act of 1958. Under this Act, the Small Business Administration licenses, regulates and finances investment companies which assist small concerns. The author describes how the Small Business Administration does this under a revised set of regulations, published in late 1973.

BACKGROUND

In 1958, Congress established a program to be administered by the Small Business Administration ("SBA"), by enacting the Small Business Investment Act of 1958 ("SBIAct").¹ Its purpose was to close the "equity gap"² which was found to affect small business adversely. The term "equity gap" denotes that area in the capital markets that lies between the banks and other institutional lenders, which are not geared to make equity or long-term investments; the SBA's programs of financial assistance to small concerns; and the public securities markets which do not favor the smaller and smallest business concerns. Accordingly, Congress declared its policy to establish: "[A] program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply"³

The SBA was created in 1953 and derives its present authority from the Small Business Act of 1958, as amended,⁴ the Small Business Investment Act of 1958, as amended⁵ and other laws. The SBA provides financial, procurement and management assistance to small business concerns and also assists victims of natural disasters, small

* This article is not subject to copyright.

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1. Act of Aug. 21, 1958, Pub. L. No. 85-699, 72 Stat. 689 (codified at 15 U.S.C. § 661 (1970)).

2. FEDERAL RESERVE BOARD, FINANCING SMALL BUSINESS (1958). See also BUREAU OF THE CENSUS, SURVEY OF REPORTS OF CREDIT AND CAPITAL DIFFICULTIES BY SMALL MANUFACTURERS (1935).

3. 15 U.S.C. § 661 (1970).

4. *Id.* § 631.

5. *Id.* § 661.

concerns required to comply with, or adversely affected by, federal programs such as environmental, safety, health or construction programs, and the handicapped. Financial assistance includes both direct and guaranteed loans.⁶ The SBI Act introduced the concept of a small business investment company ("SBIC") as a privately owned, privately managed, state-incorporated body organized solely for the purpose of performing the functions and conducting the activities contemplated by the Act. SBICs are licensed and regulated by the SBA, and in most cases, to encourage their formation and growth, the SBA extends financing to them.

The various SBA programs are supplemented by the SBIC program, which renders assistance of a kind not generally available from the SBA directly, *e.g.*, equity capital and loans with equity features. On August 31, 1973, there were 338 licensed and operating SBICs, with aggregate private capital exceeding \$350 million, which reported their outstanding loans and investments in approximately 5,000 small concerns totaling more than one-half billion dollars, most investments ranging in size from \$18,000 to \$76,000.⁷

Under present law, the SBA financing of SBICs may be subordinated to other lenders, be for a term up to 15 years, and may rise to 200% of private capital, not to exceed \$15 million; the larger SBICs (with private capital of \$500,000 or more) emphasizing venture-capital investments such as equity or other financings with subordination or non-amortization characteristics approaching the nature of equity, may receive leverage to 300% of private capital, not to exceed \$20 million, from the SBA.⁸ The SBA is also authorized to purchase the preferred stock of SBICs, which invest exclusively in small concerns owned by persons whose participation in the free enterprise system is hampered by social or economic disadvantages; there is no dollar limit on the total leverage which the SBA may make available to such specialized SBICs, commonly known as *Sec. 301(d) Licensees*, a reference to that section of the SBI Act which gave them statutory recognition.⁹

From the inception of the SBIC program over 15 years ago, to December 31, 1973, the SBA provided leverage in the aggregate amount of \$667 million to all SBICs; at the latter date, an aggregate leverage of \$453 million was outstanding. The SBA leverage initially consisted of direct loans, made by the SBA to eligible Licensees; under budgetary restraints resulting in protracted and severe funding shortages, the SBA developed a system of SBA-guaranteed funding from private investors which received statutory recognition at the end of 1971.

6. *Id.* § 636.

7. The SBA periodically publishes the latest composite financial data and statistics on investments by industry, geographical distribution, size, etc. SBA, SBIC INDUSTRY REVIEW.

8. 15 U.S.C. § 683(b) (Supp. II, 1972).

9. *Id.* § 683(c). The SBA created the program administratively in 1969. It received statutory recognition and added encouragement from the enactment of the SBI Act. For a description of this program and a summary of its legislative history see Weinmann, *A Piece of the Action for the Disadvantaged*, 31 FED. B.J. 336 (1972). See note 28 *infra*.

The SBA may guarantee the timely payment of all principal and interest as scheduled on SBIC debentures.¹⁰ These debentures may be pooled and sold to the public through issuance of debentures fully guaranteed as to principal and interest by the SBA. The SBA guaranty is secured by the full faith and credit of the United States. As of December 31, 1973 there were \$185.4 million of these SBA guaranteed debentures outstanding. They had a term of 10 years and carry interest rates ranging from 7%-7-3/8%. The debentures were issued in \$10,000 denominations and were not redeemable prior to maturity.

From the original enactment to the present time, Congress has amended the SBA Act at almost every session.¹¹ The trend of these amendments has been threefold:

- (1) To increase the flexibility of SBICs in their use of financing modes, so that today virtually every long-term financing method is available;
- (2) To increase the regulatory power of the SBA to curb abuses which have developed;
- (3) To increase the leverage available from the SBA, or with the SBA's guaranty.

In response to these amendments, the SBA has continually updated its regulations under the SBA Act¹² by adopting five revisions, each of which was repeatedly amended. The fifth and current revision¹³ is the subject of this article. Rev. 5 omitted the SBA's Audit Guide for SBICs, which previously appeared as an Appendix of the regulations, and its System of Account Classifications, previously a separate part of the SBA's regulations;¹⁴ these documents will be separately printed and distributed by the SBA and are to be followed by SBICs and their auditors.¹⁵ As in prior revisions, the forms to be used by SBICs, and the relevant instructions are incorporated by reference in the regulation, and are thus mandatory.¹⁶

Generally speaking, the regulations are the same for Sec. 301(d) Licensees and for other Licensees not specializing in investments in disadvantaged concerns. There are, however, certain differences which will be noted in this discussion.

10. 15 U.S.C. § 683(b) (Supp. II, 1972); see 13 C.F.R. § 107.201(b) (1974) (implementing this authority). For a description of the guaranteed financing process see Chase & Weinmann, *This Little Agency Went to Market*, 89 BANK. L.J. 195 (1972).

11. Act of Oct. 27, 1972, Pub. L. No. 92-595, § 2, 86 Stat. 1314; Act of Dec. 22, 1971, Pub. L. No. 92-213, § 10, 85 Stat. 776; Act of Oct. 11, 1967, Pub. L. No. 90-104, §§ 201-11, 81 Stat. 269; Act of Nov. 6, 1966, Pub. L. No. 87-779, §§ 2-7, 9, 80 Stat. 1359; Act of Feb. 28, 1964, Pub. L. No. 88-273, §§ 2-6, 78 Stat. 146; Act of Oct. 3, 1961, Pub. L. No. 87-341, §§ 2-11, 75 Stat. 752; Act of June 11, 1960, Pub. L. No. 86-502, §§ 2-6, 74 Stat. 196.

12. See generally 15 U.S.C. § 687(c) (1970) (granting the SBA regulatory power).

13. 13 C.F.R. § 107.1 *et seq.* (1974) [hereinafter cited as Rev. 5].

14. 13 C.F.R. part 111 (1973).

15. 38 Fed. Reg. 30837 n.1 (1973).

16. 13 C.F.R. § 107.2 (1974).

LICENSING

While the licensing process begins, strictly speaking, with the submission of a license application,¹⁷ the SBA has adopted informal procedures that enable proponents to obtain guidance on the proper preparation of an acceptable application. Thus, proponents may submit proposed charters and bylaws prior to voting on their adoption or filing them with state authorities. Plans of capitalization and operation may also be presubmitted, and in some instances informal prefilings conferences are held by the staff of the Investment Division with prospective applicants. Upon the filing of an application, the SBA publishes the pertinent facts for comment, usually during a period of 15 days from date of publication in the Federal Register and a similar notice is published locally by the applicant, and certified to the SBA.¹⁸

In processing a license, the SBA must first apply the statutory standards. The significant standards—apart from the obvious, such as corporate powers, duration of the corporation—are:

- (1) the demonstrated need,
- (2) the general business reputation and character of owners and management, and
- (3) the probability of successful operation from the standpoint of profitability and soundness.¹⁹

Accordingly, proponents submit data supporting the existing need for a SBIC in the proposed area of operations, personal history statements concerning the principals, and business projections based on the proposed plan of operations. In addition, the SBA must determine that the proposed private capital, which cannot be less than \$150,000, is adequate "to assure a reasonable prospect that the company will be operated soundly and profitably, and managed actively and prudently. . . ."²⁰ That an investment company must be adequately capitalized to support competent management from its inception, before investment returns can be expected, is a matter of common experience,²¹ heightened in the case of SBICs because of the greater difficulty of finding promising investments which qualify.²² Based on experience and as a result of studies on the subject of optimal size,²³ the SBA determined that in most cases a private capital of at least

17. *Id.* § 107.102.

18. *Id.* § 107.103.

19. 15 U.S.C. § 681(c) (1970).

20. *Id.* § 682(a)(2).

21. *Cf.* Investment Company Act of 1940 § 14, 15 U.S.C. § 80a-14 (1970).

22. For the purposes of the Small Business Investment Company program, a concern is small if its assets do not exceed \$7.5 million, its net worth is not more than \$2.5 million and its two-year average income after taxes does not exceed \$250,000; a concern may also qualify under the regular business loan size standards. 13 C.F.R. § 121.3-11 (1974).

23. *Hearings on S. 1862 Before the Subcomm. on Small Business of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 29 (1967).

\$300,000 is required;²⁴ smaller capitalization is acceptable in areas with no or few SBICs, and for Sec. 301(d) Licensees where a "strong parent" such as a major industrial or financial corporation undertakes to absorb operating expenses in excess of 8% per annum of private capital, and to supply management services to prevent capital depletion.²⁵

Since Sec. 301(d) Licensees fulfill a need at which other federal and state programs are also aimed, such a Licensee can sometimes obtain public grant funds toward their capitalization.²⁶ In these cases, the SBA will recognize and leverage public funds as "private capital," if these grants are "without strings" and if non-public funds are also contributed to, or used to acquire stock in, such Licensees. The reason for requiring an admixture of non-public funds lies in the basic concept of the SBIA Act.²⁷ The SBIC concept is one of partnership between private enterprise and the federal government, to assist small concerns;²⁸ private enterprise supplies investment acumen and follow-up management assistance, and backs its judgment and know-how, in part, with its own funds. Accordingly, the SBA will recognize public grant funds as "private," on the theory of their severance from the public purse, and in recognition of the profit motive of the private investor in the Sec. 301(d) Licensee. The \$150,000 minimum capital and a 10% supplement to the public grant funds must be derived from private sources.²⁹

When borrowed funds are used to acquire an interest of 10% or more of any Licensee's shares, the SBA requires such stockholder to have a net worth of at least twice the amount borrowed.³⁰ The reason for this requirement is the venture capital nature of SBIC investment; the obligation of a major stockholder to repay his loan could inhibit the Licensee from venturing, if that stockholder did not have other means to meet this obligation. In appropriate cases, the SBA may waive or modify its net worth rule.

INVESTMENT POLICY

Rev. 5 abandoned the diversification requirement of prior revisions, except as it relates to real estate: only a limited portion of the portfolio of a Licensee which is not a Sec. 301(d) Licensee may consist of

24. The Small Business Investment Act offers a third-dollar leverage incentive for a minimum capital of \$500,000. 15 U.S.C. § 683 (Supp. II, 1972).

25. SBA, MESBIC (1969). See also 13 C.F.R. § 107.101(d)(1) (1974).

26. See, e.g., Economic Opportunity Act §§ 701, 714(a)(1), 42 U.S.C. §§ 2981, 2982(a)(1) (Supp. II, 1972).

27. 15 U.S.C. § 661 (1970).

28. The "partnership" concept was reinforced when the SBA was authorized to purchase nonvoting preferred stock in section 301(d) Licensees up to the amount of private capital. 15 U.S.C. § 683(c) (Supp. II, 1972).

29. 13 C.F.R. § 107.101(d)(2) (1974).

30. *Id.* § 107.101(e).

permissible real estate investments.³¹ No such limitation is imposed on Sec. 301(d) Licensees. The regulation recognizes the SBA's past practice, no longer in effect, of licensing "real estate specialists," who may maintain an approved larger portion. "Real Estate Investments" are defined as those real estate related investments classified under Major Groups 15 (Building Construction), 65 (Real Estate—within that group only certain industries are acceptable) and 70 (Hotels and other lodging places). No more than one-third of the portfolio may be maintained in one, nor more than two-thirds in any combination of the three groups.³² Sec. 301(d) Licensees are not limited, in recognition of their special mission to facilitate business entry of their constituency.

Sec. 301(d) Licensees are required to include an investment policy in their charter which limits their investments to disadvantaged concerns.³³

CONTROL OF LICENSEE

In recognition of the statutory requirement of the SBA's approval for the principals of an SBIC, a license may not be transferred,³⁴ nor may control over a Licensee be transferred without the SBA's approval. The regulations subject not only the transfer of full control, but also lesser transfers which may result in control over 10 or more percent of the stock, to the SBA's scrutiny. In view of the possibility of a transfer without the Licensee's or the SBA's knowledge, the regulations bar the Licensee from recognizing such a transfer which has not been approved by the SBA. The regulations further give the SBA a right in the case of closely held SBICs to hold unauthorized transferors personally liable, by express contract, for the SBICs' indebtedness to the SBA, such liability to terminate on the SBA's approval of such transfer. The formalities and standards involved in the SBA's approval of a transfer of control are patterned on those involved in an original license grant, since there is little substantive difference between license acquisitions by original grant, or by transfer of control over a Licensee.³⁵ A correlation to the foregoing provision is that requiring notification to the SBA in the event of the pledge by a stockholder of as much as 10% of an SBIC's stock, since it is in the nature of a pledge that ownership of the stock parcel involved may be transferred to the pledgee.³⁶

The SBIA Act gives the SBA the power to control the amount of shares that anyone may own in one or more SBICs.³⁷ The SBA has exercised

31. *Id.* § 107.101(c)(1).

32. OFFICE OF MANAGEMENT AND BUDGET, STANDARD INDUSTRIAL CLASSIFICATION MANUAL (1972).

33. 13 C.F.R. § 107.205(a)(1) (1974).

34. *Id.* § 107.104.

35. *Id.* § 107.701; *cf.* Federal Communications Act, 47 U.S.C. § 310(b) (1970).

36. 13 C.F.R. § 107.703 (1974).

37. 15 U.S.C. § 682(c) (1970).

that power by subjecting common control over two or more SBICs to its approval, but has exempted Sec. 301(d) Licensees from this requirement³⁸ since it is the SBA's policy to encourage the formation of Sec. 301(d) Licensees by other Licensees³⁹ as well as by non-Licensees.

The SBI Act limits the amounts of voting stock that a federally regulated bank⁴⁰ may acquire to less than 50% of such voting stock and to 5% of such bank's capital and surplus.⁴¹ Prior to 1968, there was no limitation on the percentage of voting stock that such a bank could acquire, and there are several bank-owned SBICs, licensed before the effective date of the 1967 amendments. Such banks may increase their stockholdings in their SBIC so long as they do not also increase the percentage of their voting control.⁴² Beyond this, the bank ownership limitation has caused numerous interpretive problems, relating to the ownership of voting stock by several banks, or the combined ownership of a SBIC by a bank and persons related to it or the combined ownership by a bank of voting and nonvoting stock. In these instances, the SBA's interpretations have been guided by the spirit of the statute, since a literal reading would not reach such situations. Generally speaking, the SBA has approved such combined holdings where the majority holding was not, in fact, subservient to the bank.

LEVERAGE

Sections 303(b) and (c) of the Act authorize the SBA to leverage the private capital of a SBIC. "Private capital" is defined as the combined private paid-in capital and paid-in surplus, and excludes the SBA's preferred stock capital and borrowed funds.⁴³ A Licensee may issue its stock for cash or cash equivalent, services and physical assets (not to exceed their fair market value), as a stock dividend, or in connection with a merger, reorganization or reclassification approved by the SBA. However, a SBIC may not issue stock in exchange for eligible portfolio securities (other than U.S. Government securities), except that a Sec. 301(d) Licensee formed with the participation of another Licensee⁴⁴ may issue stock for securities of disadvantaged small concerns; in any event the minimum capital must, in all cases, be contributed in cash or

38. 13 C.F.R. § 107.702 (1974).

39. *See generally* 13 C.F.R. § 107.813 (1974).

40. *See also* Bank Hold Company Act § 4(c)(5), 12 U.S.C. § 1843(c)(5) (1970); 12 C.F.R. § 225.111 (1973). An intriguing question is whether the Board of Governors of the Federal Reserve System has the power, under § 1843(c)(8), to determine that Small Business Investment Company activity is sufficiently related to banking as to be a proper incident thereto. Such a determination would permit a regulated bank holding company wholly to own a Small Business Investment Company, § 1843(c)(5) notwithstanding. *See generally Implementation of the Bank Holding Company Act Amendments of 1970: The Scope of Banking Activities*, 71 MICH. L. REV. 1170 (1973).

41. 15 U.S.C. § 682(b) (1970).

42. 13 C.F.R. § 107.811 (1974).

43. *Id.* § 107.3.

44. *Id.* § 107.813(c).

cash equivalent.⁴⁵ The capital represented by stock issued for such consideration, is eligible for leveraging by the SBA. In rare cases, the SBA will allow stock issues for other considerations, but will not leverage the capital represented by such stock.

Generally speaking, the SBA is authorized to leverage private capital up to twice,⁴⁶ but in the case of SBICs with private capital of \$500,000 or more and which are venture-capital oriented, the SBA may leverage private capital up to three times.⁴⁷

A Licensee with qualifying private capital will be considered venture-capital oriented if it has at least 65% of its available funds invested in "venture capital financings" of eligible small concerns, except that a Sec. 301(d) Licensee need only have 30% so invested.⁴⁸ "Venture capital financings" are defined as being represented by shares of stock or stock warrants, or by subordinated debt securities which are not amortizable during the first three years.⁴⁹

SBICs eligible for 200% leverage may not receive leverage in excess of \$15 million, but there is *no* dollar limit for Sec. 301(d) Licensees. Similarly, the leverage limit for venture-capital oriented SBICs is \$20 million, but there is *no* such limit for Sec. 301(d) Licensees.⁵⁰

The SBA may leverage SBICs through the purchase or guaranty of their debentures, which will be subordinated to all creditors unless the SBA "in its exercise of reasonable investment prudence and in considering the financial soundness of such [SBIC] determines otherwise."⁵¹ Since 1970, the SBA has relied almost entirely on the public securities market for leveraging SBICs not licensed pursuant to Sec. 301(d).⁵² To ensure the uniformity of these debentures, the SBA adopted their terms as a regulation⁵³ and incorporated the regulations into the debentures by reference with the assurance that in respect to any given debenture the regulation would remain in force.

Resort to the public market has resulted in interest rates roughly equal to those of other government-guaranteed securities. Sec. 301(d) Licensees, however, have received direct loans from the SBA and have enjoyed interest rates on their debentures which, by statute,⁵⁴ are three percentage points below market rates during the first five years. This interest subsidy, however, must be repaid before a Sec. 301(d)

45. *Id.* § 107.805.

46. 15 U.S.C. §§ 683(b)(1), (c)(2) (iii) (Supp. II, 1972).

47. *Id.* §§ 683(b)(2), (c)(2)(iii). *See* p. 192 *infra*.

48. 13 C.F.R. § 107.202(a) (1974).

49. *Id.* § 107.202(b).

50. 15 U.S.C. §§ 683(b)(1)-(2), (c)(2)(iii) (Supp. II, 1972).

51. *Id.* § 683(b).

52. *See also* p. 185 & note 10 *supra*.

53. 13 C.F.R. § 107.203(b)(7) (1974) (expressing the general rule of subordination of the debentures).

54. 15 U.S.C. § 687i (Supp. II, 1972). The interest rate on debentures issued before Oct. 13, 1971, the date of the Presidential message proposing what was to become the Act of Oct. 27, 1972, Pub. L. No. 92-595, § 2(g), 86 Stat. 1316 (codified at 15 U.S.C. § 687i (Supp. II, 1972)), was reduced for five years from that date.

Licensee may make any distribution, whether from profits or otherwise, to stockholders other than the SBA. The subsidy is, therefore, both temporary and conditioned on the pretermission of distributions, in the expectation that any available funds will be invested in disadvantaged small concerns.⁵⁵ “The purpose of this provision is to assure the SBA of a fair return before any distribution to private stockholders.”⁵⁶ Within the limits stated above,⁵⁷ the SBA may purchase, from Sec. 301(d) Licensees only, their nonvoting preferred stock up to a par value equaling their private capital. This stock carries a 3% cumulative dividend, which is payable in the sound discretion of the Board of Directors.⁵⁸ While the subsidy involved in this low dividend rate is not temporary, but may continue as long as the preferred stock is outstanding to the SBA, its continuance may also be conditioned on abstaining from distributions, since the SBA has discretionary authority to require the payment of the difference between dividends actually paid, and the government’s own cost of money at the time of its purchase of preferred stock before allowing a Sec. 301(d) Licensee to distribute any assets to other stockholders. “This dividend provision complements that requiring reimbursement of the debenture interest subsidy, so that the SBA’s fair return ahead of private shareholders is assured in both cases.”⁵⁹ It is submitted that the SBA should exercise its discretionary authority to maximize *investment* in disadvantaged concerns, rather than *distribution* to stockholders. Since Congress has contrasted the 3% dividend rate with a “fair return,” it would follow that a return which is not fair to the SBA should be put to program (as distinguished from private) use.

A Sec. 301(d) Licensee has the option to retire the SBA’s preferred stock on any dividend date by paying the SBA the par value thereof. In such event, the SBA is entitled to a “rain check” for the dividend subsidy, to be cashed if the SBA elects to do so, before a distribution to other stockholders.⁶⁰ By this means a SBIC can stop the dividend subsidy from cumulating further, without incurring an obligation to pay the dividend subsidy at that time. Since the dividend subsidy is defined as the difference between dividends actually paid and the federal government’s cost of money, it follows that the unpaid part of the cumulated 3% dividend is not payable at call time, but is included in the “rain check.”

Similarly, on redemption of stock from other stockholders, or liquidation in whole or in part, or any other distribution of assets, *e.g.*, spin-off, which is not an ordinary dividend payable from retained

55. 13 C.F.R. § 107.205(a)(2)(iv) (1974).

56. S. REP. No. 1007, 92d Cong., 2d Sess. 5 (1972). See also H. R. REP. No. 1428, 92d Cong., 2d Sess. 9 (1972).

57. 15 U.S.C. §§ 683(b)(2), (c)(2)(iii) (Supp. II, 1972).

58. 13 C.F.R. § 107.205(a)(2) (1974).

59. S. REP. No. 1007, *supra* note 56. See also H.R. REP. No. 1428, *id.* at 7; see p. 196 & note 105-06 *infra*.

60. 13 C.F.R. § 107.205(a)(2)(ii) (1974).

earnings, the SBA is entitled to the par value of its preferred stock, the interest subsidy and to the "rain check."⁶¹

Any Licensee which has received three-for-one leverage must maintain the capital requirement (minimum: \$500,000) and the venture capital ratio to total available investment funds (30% for Sec. 301(d) Licensees, 65% for other Licensees) as of the end of each fiscal year during which third-dollar leverage remains outstanding,⁶² and failure to do so entitles the SBA to accelerate the third-dollar leverage.⁶³ The SBA is authorized to mitigate this remedy in appropriate cases, such as prepayments or capital increases.

All debt leverage is subject to acceleration on (1) default of payment of principal or interest to the SBA, (2) failure to inform the SBA within 20 days of default on a debt to some one other than the SBA, (3) violation of the Act or regulations, (4) nonperformance of a written agreement with the SBA, or (5) the making of a false statement to the SBA.⁶⁴ Insolvency and acts of bankruptcy⁶⁵ trigger automatic acceleration, to preserve, if possible, the statutory federal priority⁶⁶ and to avoid the result of *United States v. Marxen*,⁶⁷ where the SBA has guaranteed the SBIC debt to a third party holder.

Capital impairment, formerly a violation of the regulations,⁶⁸ is no longer a violation. A Sec. 301(d) Licensee with a retained earnings deficit equaling its private capital, or another Licensee with a deficit equaling one-half thereof, are now required to notify the SBA promptly, and must cure such impairment within a time limit set for each case by the SBA. Failure to do that entitles the SBA to accelerate the SBIC's debt.⁶⁹

FINANCING SMALL CONCERNS

The SBIAct contemplates two basic methods of financing by SBICs,

61. *Id.* § 107.205(a)(2)(ii) (1974).

62. *Id.* § 107.202(d).

63. *Id.* §§ 107.203(b)(6), (c); see note 47 *supra*.

64. *Id.* §§ 107.203(b)(1), 107.1008; cf. 15 U.S.C. § 687(d) (1970).

65. Bankruptcy Act § 3, 11 U.S.C. § 21 (1970).

66. Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

31 U.S.C. § 191 (1970).

67. 307 U.S. 200 (1939) (where the federal priority was held not applicable to a general claim in bankruptcy transferred to the United States after bankruptcy petition was filed). Acceleration is matched by a corresponding subrogation provision in the guaranty instrument. This issue has lost importance, since most leverage remaining outstanding is subordinated and, therefore, does not enjoy the federal priority.

68. 38 Fed. Reg. 30845 (1973) (reserving 13 C.F.R. § 107.1002).

69. 13 C.F.R. § 107.203(d) (1974).

equity capital⁷⁰ and loans.⁷¹ In practice, the distinction between these two financing methods is blurred, since the SBA regards loans with equity features as equity capital.⁷² This position is supported by the Act itself, which includes in "venture capital" "such common stock, preferred stock, or other financing with subordination or nonamortization characteristics as the Administration determines to be substantially similar to equity financing."⁷³ Loans may be made in participation with other lenders and participation may be deferred. In SBA parlance, a deferred participation is a guaranty, and such guaranties are limited by the statute to 90% of the outstanding balance. SBIC financing can take the form of stock purchases (common or preferred), warrants to purchase such stock, limited partnerships, or equity investments in other unincorporated concerns,⁷⁴ debt instruments which provide either for conversion to stock or which have stock purchase warrants attached, and any combination of the foregoing.

Equity investments in unincorporated concerns are fraught with the danger that the investor may become liable for the general obligations of the unincorporated concern. For example, § 7 of the Uniform Limited Partnership Act (ULPA) subjects a limited partner to general liability for partnership debts if he oversteps statutory restrictions against management participation. Similarly, a "special" or "silent partner" may become liable if he acts in any manner for the partnership⁷⁵ or participates in a misstatement of the partnership.⁷⁶

General liability may ensue when a limited partner holds partnership property as collateral for a loan⁷⁷ or when a limited partnership interest is redeemed with partnership property.⁷⁸ Congress was aware of this danger when it permitted such investments⁷⁹ by stating: "It is not intended to subject SBICs to the liability of their portfolio concerns. The Administration is expected to regulate this new authority to the exclusion of such a contingency . . ."⁸⁰ Accordingly, the regulation provides that a Licensee acquiring an equity position in a small concern, may not "become a general partner . . . or otherwise become jointly or severally liable for the general obligations of an unincorporated Portfolio Concern, inadvertently or otherwise . . ."⁸¹ except through a guaranty, as discussed below.⁸² This provision was adopted

70. 15 U.S.C. § 684(a) (Supp. II, 1972).

71. *Id.* § 685(a) (1970).

72. 13 C.F.R. § 107.302(b) (1974).

73. 15 U.S.C. § 683(b) (1970).

74. Equity investments in unincorporated businesses were barred until the enactment of the Act of Oct. 27, 1972, Pub. L. No. 92-595, § 2(e), 86 Stat. 1316, amending 15 U.S.C. § 684(a) (1970) (codified at 15 U.S.C. § 684(a) (Supp. II, 1972)).

75. 60 AM. JUR. 2d *Partnership* §§ 381-82 (1972).

76. *Abendroth v. Van Dolsen*, 131 U.S. 66 (1889).

77. UNIFORM LIMITED PARTNERSHIP ACT § 13.

78. *Id.* § 22.

79. 15 U.S.C. § 684(a) (Supp. II, 1972).

80. H.R. REP. No. 1428, 92d Cong., 2d Sess. 9 (1972).

81. 13 C.F.R. § 107.302(a) (1974).

82. See p. 194 & note 89 *infra*.

over a proposal⁸³ to require an unincorporated portfolio concern to include in its contracts and related correspondence a disclaimer, similar to that used by Massachusetts business trusts, limiting liability to the unincorporated concern's own assets, and disclaiming liability of its investors.⁸⁴ It was felt that such disclaimer would be burdensome,⁸⁵ and perhaps ineffective. Since the possibilities of general liability are numerous, and a regulation guarding against them would have to be inordinately detailed, the SBA left the responsibility of avoiding these pitfalls to SBIC's management with a warning that intent to become liable is not a necessary element of a violation.

Rev. 5 substantially liberalizes the implementation of the statutory authorization of deferred participation,⁸⁶ over that of prior revisions. Subject to the general limitations applicable to all forms of financial assistance, a Licensee may now guarantee the monetary obligation of a small concern to any creditor (including a trade creditor) who is not an Associate of the Licensee,⁸⁷ up to 90% of the obligation⁸⁸ so long as the total amount of all such guarantees does not exceed the private capital. The Licensee must maintain a funded reserve of 10% against all such guarantees. Associates of the Licensee may also become guaranteed creditors,⁸⁹ subject to the regulation of conflicts of interest, discussed below.

In addition to immediate financing, a SBIC may also enter into a commitment to finance a small concern; and charge a commitment fee. The regulation adjusts the minimum periods for which financings must be made, to permit shorter maturities so long as the aggregate periods of commitment and financing equal at least the 5-year minimum period discussed immediately hereafter.⁹⁰ The purpose of permitting commitments is to reduce the financing cost to the small concern, which may have no immediate need for the funds, although it needs the assurance of future availability, or the small concern may wish to establish a line of credit with a third party, based on the SBIC's commitment.

The purpose clause of the SBIA Act makes it clear that SBICs are designed to furnish equity capital and long term loans to small concerns.⁹¹ Accordingly, the SBA has fixed the minimum maturity of investments in general at 60 months, except that financings of disadvantaged small concerns⁹² may be made by any Licensee, not only a

83. 38 Fed. Reg. 4519 (1973).

84. J. BOGEN, *FINANCIAL HANDBOOK* 376 (3d ed. 1962).

85. NASBIC News, Feb. 27, 1973, at 4.

86. 15 U.S.C. § 685(b) (1970). The Act of Oct. 3, 1961, Pub. L. No. 87-341, § 6, 75 Stat. 753, substituted "other lenders, incorporated or unincorporated" for "other lending institutions." This made guarantees to a larger class of creditors possible.

87. 13 C.F.R. § 107.3 (1974) (for the definition of "Associate of a Licensee").

88. 15 U.S.C. § 685(b) (1970). While the regulations do not state so, the 90% figure is computed on the balance at time of disbursement, as distinguished from the face or original amount.

89. 13 C.F.R. § 107.501 (1974).

90. *Id.* § 107.503.

91. 15 U.S.C. § 661 (1970).

92. 13 C.F.R. § 107.3 (1974).

Sec. 301(d) Licensee, for thirty months, so long as the total amount of such financings does not exceed 50% of that Licensee's portfolio. Prepayment, subject to a reasonable penalty, must be permitted; restrictions on prepayment (other than such penalty) require the approval of the SBA.⁹³

In line with the minimum maturity, the regulations also fix maximum amortization, which as a general rule may not exceed, on the average and in the aggregate, the limits of the straight-line method.⁹⁴ An exception to the foregoing rules gives greater flexibility to Licensees, to the extent of 20% of their "total adjusted assets."⁹⁵ Where it becomes necessary, as part of an overall financing arrangement, or to protect an existing investment, or to finance a change of ownership,⁹⁶ a SBIC may extend short-term financing (of less than 60 or 30 months, respectively) to a small concern.⁹⁷ In addition, also within this limitation, a SBIC may hold 60-months loans, but not loans of shorter maturity, amortizable at a rate not to exceed 40% of the declining principal balance.⁹⁸

All financings are subject to a statutory maximum for each loan.⁹⁹ Without the approval of the SBA, a Licensee may not invest in and commit to or on behalf of any small concern¹⁰⁰ more than 20% of its private capital. For Sec. 301(d) Licensees, the SBA has raised this limit to 30%. The purpose of this rule is diversification; given the risk of small business investments, it is undesirable for a SBIC to have "too many eggs in one basket." For the same reason, write-downs of existing investments are not considered in computing the applicable percentage.¹⁰¹

All financings (other than purchases of securities not bearing a stated return, such as common stock, not subject to compulsory redemption or "put") are further subject to a cost-of-money limitation of 15% per annum.¹⁰² However, since SBICs are required to comply with all

93. *Id.* § 107.301(a). *But see* note 97 *infra*.

94. *Id.* § 107.301(b). *But see* note 97 *infra*.

95. *Id.* § 107.504(a). "Total adjusted assets" are defined as total assets less indebtedness to the SBA and liabilities with a maturity of one year or less. The 20% of "total adjusted assets" includes small business securities purchased from other than the issuer small concern itself.

96. *Id.* § 107.812 (standards for the financing of ownership change).

97. *Id.* § 107.504(b).

98. *Id.* § 107.504(b) (2).

99. 15 U.S.C. § 686(a) (Supp. II, 1972).

100. 13 C.F.R. § 107.3 (1974) (including "affiliates" of small business concerns within the definition of "small concern").

Affiliates: Concerns are affiliates of each other when either directly or indirectly (1) one concern (other than an investment company licensed under the Small Business Investment Act of 1958 or registered under the Investment Company Act of 1940, as amended), controls or has the power to control the other, or (2) a third party or parties (other than an investment company licensed under the Small Business Investment Act of 1958 or registered under the Investment Company Act of 1940, as amended), controls or has the power to control both.

Id. § 121.3-2(a) (1974).

101. *Id.* § 107.301(d) (1974).

102. *Id.* § 107.301(c).

applicable laws,¹⁰³ a lower rate prescribed by state statute would prevail over the SBA's maximum rate.¹⁰⁴ Cost of money is defined as the sum of all charges of whatever description, other than management and certain closing fees,¹⁰⁵ imposed on the small concern.¹⁰⁶ The purpose of this regulation is the protection of the small concern, which is not always in a strong bargaining position when it seeks financing.

Equity financings are subject to restrictions related to control over the small concern. The Small Business Act defines a small concern as one: "which is independently owned and operated . . .".¹⁰⁷ The regulations state that the SBIAct "does not contemplate that Licensees shall operate business enterprises or function as holding companies exercising control over such enterprises."¹⁰⁸ Activities not contemplated by the SBIAct violate the regulations.¹⁰⁹ The SBA has not prohibited control altogether, since it may become necessary for the protection of an investment. A requirement of prior approval, in situations that may be emergencies, would not be practical. The SBA, therefore, permits the assumption of temporary control and requires a plan of divestiture, and a justification of the necessity for taking control. Such plan and justification must be filed for the SBA's approval within 30 days after assuming control. The divestiture plan must be enforceable by the small concern or its stockholders, it must be completed within a reasonable time which cannot exceed 7 years, and must be certified as fair by the parties. The SBA's approval, which (without objection from the SBA) will be deemed given after 90 days from filing, is a condition of the continuance of the license. Divestiture plans must be adjusted to changed circumstances.¹¹⁰ Control is defined as the power to direct the management or policies of a business.¹¹¹ This definition parallels that under the Small Business Act.¹¹² It differs, however, in one important respect: while ownership of 50% of the votes in a closely held concern, or 25% in a concern with more than 50 shareholders, is presumed to be control, the potential ownership of stock through

103. *Id.* § 107.802.

104. National Banks are limited to the legal rate applicable in their state for state banks, and to a formula rate where state law is silent. National Bank Act, 12 U.S.C. § 85 (1970). An excess rate works a forfeiture on the entire interest. National Bank Act, 12 U.S.C. § 86 (1970). No such limitation or forfeiture is contained in the Small Business Investment Act, but since Small Business Investment Companies are organized under state law, they are generally subject to state law. 13 C.F.R. § 107.802 (1974). *Cf.* 15 U.S.C. § 681(a) (1970). Where state law does not protect corporate borrowers, the SBA's statutory mission to aid small business requires an interest ceiling. *See* 15 U.S.C. § 631(a) (1970).

105. 13 C.F.R. §§ 107.601, 107.1004(d) (1974).

106. The cost of money computation includes all charges, whether levied for the benefit of the licensee, or for the benefit of a third party.

107. 15 U.S.C. § 632 (1970). *Accord*, 15 U.S.C. § 662(5) (1970).

108. 13 C.F.R. § 107.901(a) (1974).

109. *Id.* § 107.803.

110. *Id.* § 107.901(d).

111. *Id.* § 107.3. *Cf.* Investment Company Act of 1940 § 2(a)(9), 15 U.S.C. § 80a-2(a)(9) (1970). *See generally* II L. LOSS, SECURITIES REGULATION 770-87 (2d ed. 1961).

112. 13 C.F.R. § 121.3-16(c) (1974).

conversion or option privileges is not considered.¹¹³ On exercise of the options, if control results, the justification and divestiture plan becomes mandatory.

Since a basic purpose of the SBIA Act is the provision of funds to small concerns, the general rule is that small business securities may only be acquired from their issuer.¹¹⁴ There are, however, exceptions to this general rule. One exception is the financing of an ownership change. Such change may become desirable for many reasons: a dissident co-owner may hurt a small concern; a concern may wish to dispose of a division, or may have to do so for antitrust reasons, and the division may have the potential of becoming a viable independent small concern; an owner may want to retire, or an owner may sell his business to a disadvantaged person. In such cases, a SBIC may finance the change by extending financing to the new owners, notwithstanding that such funds do not inure to the small concern, but are used to buy out the former owners.¹¹⁵

Another exception is available for the purchase of securities in an underwriting. Here, a Licensee may act as a "stand by" underwriter, purchasing a certain amount of eligible securities within the "overline" limit¹¹⁶ in a public underwriting, provided that such public offering is at least 50% "primary," i.e. on behalf of the issuing small concern, rather than of a selling stockholder, and the purchase is made within 90 days after the public offering is first lawfully made.¹¹⁷

Both the change of ownership financing and the purchase from an underwriter must fit within the same 20% limitation which also includes short-term financing and financing with rapid amortization.¹¹⁸

MANAGEMENT SERVICES

Providing advisory services is one of the three basic statutory functions of a SBIC,¹¹⁹ along with equity investments in and loans to small

113. See 13 C.F.R. § 107.901(b) (1974). *But see* 13 C.F.R. § 121.3-16(c)(4) (1974) (emphasis added) which states:

Stock options and convertible debentures exercisable at the time of, or within a relatively short time after a size determination, and agreements to merge in the future, are considered as having a present effect on the power to control the concern. Therefore, in making a size determination, such options, debentures, and agreements are treated as though the rights held thereunder had been exercised prior to the date of the determination.

Accord, North Am. Co. v. SEC, 327 U.S. 686, 693 (1946): "Domination may spring as readily from subtle or unexercised power as from arbitrary imposition of command."; Rochester Tel. Corp. v. United States, 307 U.S. 125, 145-46 (1939).

114. See 15 U.S.C. § 684(a) (1974).

115. 13 C.F.R. § 107.812 (1974).

116. *Id.* § 107.301(d).

117. *Id.* § 107.504(a), (b)(3).

118. *Id.* § 107.504(a).

119. 15 U.S.C. § 687(b) (1970).

concerns.¹²⁰ The regulations permit such services, which must be technical as distinguished from executive, to relate to financial, management, administrative or operating activities of a small concern, but such services may not lead to the exercise of control.¹²¹ Where a Licensee agrees to perform such services, they must be approved each year by the principals of the small concern, and by the SBA.¹²² Charges for such services must be competitive, and the Licensee must maintain records of time spent and charges made.¹²³ The Licensee may perform such services through an Associate, including its own investment/adviser manager¹²⁴ (subject to the conflicts-of-interest regulation¹²⁵), through an independent consultant under contract,¹²⁶ or through a wholly owned subsidiary under the Licensee's close and responsible supervision.¹²⁷ All are subject to the SBA's approval.

RESTRICTIONS ON CONFLICTS OF INTEREST

Sec. 312 of the SBIAct requires the SBA to control conflicts of interest which may be detrimental to portfolio concerns, to the SBIC or to the stockholders of either. Such conflicts may arise in transactions of the SBIC with shareholders, officers, or directors of the SBIC, or in transactions with small concerns in which such insiders have an interest, or in reciprocal transactions between concerns in which insiders have an interest, and other SBICs. In these cases the SBA evaluates the transaction, and if it finds it otherwise acceptable, it makes public disclosure before approval, to give third parties the opportunity of timely comment.

This statutory requirement is implemented by the regulations, which define "Associate of a Licensee,"¹²⁸ and require prior SBA approval of transactions involving such Associates. Self-dealing to the prejudice of the SBIC and its shareholders, the small concern, or the SBA is flatly prohibited;¹²⁹ as a creditor, the SBA must also protect its own interests. The definition of "Associate" is fairly involved, but can be summarized as concerning all "insiders" of the SBIC, such as officers, directors, major stockholders and control persons, their close relatives

120. A SBIC may also render services such as generation of business, initial investigation and servicing of small business investments for other investors and lenders. Conversely, it may utilize and pay for such services from other investors with which it is not otherwise affiliated.

121. 13 C.F.R. §§ 107.3, 107.901 (1974) (respectively defining and regulating "control").

122. *Id.* §§ 107.601(a). *Contra*, 13 C.F.R. § 107.601(a) (1973) (where such annual approval was not required).

123. 13 C.F.R. § 107.601(a) (1974).

124. *Id.* §§ 107.3, 107.809(a) (respectively defining and regulating the "Investment Adviser/Manager").

125. *Id.* § 107.1004(d).

126. *Id.* § 107.601(b).

127. *Id.* § 107.601(c).

128. *Id.* § 107.3.

129. *Id.* § 107.1004(a).

and persons controlled by or controlling the “insiders” of the SBIC. Sec. 107.1004 subjects to public disclosure and SBA approval:

- (1) financing extended to an Associate,
- (2) financings among two or more SBICs and small concerns (pursuant to an understanding that these financings will be made in reciprocal or circular fashion),
- (3) borrowing from a portfolio concern or its insiders,
- (4) financings to enable a small concern to repay an Associate, or
- (5) to purchase property from an Associate.¹³⁰

To this last restriction, there is an exception for an Associate who is a regular supplier of the small concern: in that 50% of the financing proceeds may be used to purchase goods and services from such supplier, and a disadvantaged small concern financed by a Sec. 301(d) Licensee may use 75% of its financing proceeds. The purpose of this exception is, for example, to permit franchisors to finance and supply their franchisees with the help of an operating SBIC, or permit wholesalers to finance their retail distributors. However, the exception is available only for purchases from a regular supplier, not for occasional or infrequent transactions.¹³¹

The conflicts regulation also requires that joint financing by a SBIC and its Associate may not be less favorable to the SBIC than to the Associate, and the burden of proving at least parity is on the SBIC.¹³²

The regulation further restricts payment of compensation by portfolio concerns to Associates. Finder's fees, kickbacks and the like are restricted,¹³³ but fees for *bona fide* closing services may be paid.¹³⁴ An Associate may also perform management services for a small concern, subject to the SBA's annual approval, but in that case the Licensee is responsible for the reasonableness of the fee, and the Licensee must collect the fee and pay the Associate.¹³⁵

It is a common practice of venture capitalists to require a portfolio concern to elect as a director, or otherwise admit to the inner circle, a representative of the investor, commonly known as the “watch dog.” The regulation allows for the practice by exempting the “watch dog” relationship from the restriction otherwise barring such affiliation, but the “watch dog” may not be a member of the small concern's inner circle in his own right or have a personal stake in the small concern. This prevents circumvention of the conflicts rule by nominating as “watch dog” an insider whose personal interest may disqualify the small concern from financing without the approval of the SBA.¹³⁶

130. *Id.* § 107.1004(b).

131. *Id.* § 107.1001(g). Where financing is tied in with sales, the antitrust laws may apply. *Fortner Enterprises v. United States Steel*, 394 U.S. 495 (1969).

132. 13 C.F.R. § 107.1004(c) (1974).

133. 18 U.S.C. § 216 (1970) (which declares such payments to be a criminal offense).

134. 13 C.F.R. § 107.1004(d) (1974).

135. *Id.* §§ 107.601(b), 107.1004(d).

136. *Id.* § 107.1004(f).

Another regulation subjects the sale of SBIC assets to SBIC Associates, and the sale of portfolio securities to a competitor of the small concern involved, to certain safeguards.¹³⁷ In requesting the SBA's approval of an asset sale to an insider, the SBIC must demonstrate that the sale is at least as favorable as an arm's-length transaction. In selling to a competitor, if the small concern is not under the SBIC's control, it must agree to the sale, or the SBA must approve. It is evident that asset sales to insiders may harm the SBIC and the SBA's creditor position. It would be inconsistent with the SBA's role as the protector of small business to permit a SBIC to sell out a portfolio concern to its competitors but the regulation does not bar such a sale with the portfolio concern's free consent, or with the SBA's approval.

OTHER RESTRICTIONS AND PROHIBITIONS

Since a SBIC almost always operates with government funds, the SBA must make sure that such funds achieve their proper destination. It could not do so, if a SBIC could finance small concerns which, in turn, would reinvest these funds in other concerns which may or may not be eligible for SBIC assistance. Accordingly, the regulations bar financing for reinvestment as a general proposition. An exception is provided for young financial concerns owned by disadvantaged persons, if such concerns are not banks, agricultural credit companies, or thrift institutions which are not federally insured. Securities dealers, federal savings and loan associations and certain other financial concerns suited to capital formation among the disadvantaged may receive venture capital investments¹³⁸ from any Licensee, up to the amount of such Licensee's private capital.¹³⁹

Another regulation prohibits SBIC financing for SBIC capitalization.¹⁴⁰ Not only would such financing violate the prohibition against reinvestment, but it would dilute the private investment which the SBA leverages. Private enterprise initiative is a basic ingredient of the SBIC program.¹⁴¹ For this reason, SBIC funds, leveraged by, or eligible for leverage from the SBA may not be used, directly or indirectly, to provide any part of another SBIC's private capital. An exception to this general rule is provided for the formation of Sec. 301(d) Licensees by other SBICs: capital contributions to such Licensees are permitted for that part of their private capital which exceeds the statutory minimum of \$150,000.¹⁴² However, leverage funds may not be used to provide capital which could be again leveraged by the SBA; such contributions are, therefore, equated with capital reductions of the contributor. The

137. *Id.* § 107.1005.

138. *Id.* § 107.202(b).

139. *Id.* § 107.1001(a).

140. *Id.* § 107.1001(b).

141. *See* p. 187 & note 28 *supra*.

142. *Cf.* p. 187 & note 29 *supra* (the 10% cash supplement is not required).

SBA also requires that a SBIC participating in the formation of a Sec. 301(d) Licensee have at least a 20% interest, or otherwise demonstrate that it will be an active investor in the Sec. 301(d) Licensee.¹⁴³

Since housing and other real estate-related activities are the particular concern of other federal programs, the SBA has restricted its own assistance to such activities.¹⁴⁴ Logically, SBIC assistance to such activities is also restricted. In addition to the restrictions outlined before,¹⁴⁵ real estate operators, owners and lessors of real property, as well as buyers and sellers of real estate are barred from SBIC assistance,¹⁴⁶ but subdividers and developers, and certain other real estate-related activities which constitute an active and continuous business operation are eligible.¹⁴⁷ The financing of real estate acquisitions by eligible real estate concerns is subject to the requirement of prompt and substantial improvement. The regulation allows for the possibility that a planned real estate development may sometimes fall through. Accordingly, while acquisition of land for speculative purpose, *i.e.* without prompt and substantial improvement, is barred, a showing of changed circumstances will excuse the failure of such improvement.¹⁴⁸

Agriculture is also the concern of other federal programs. Accordingly, the financing of agricultural activities is prohibited. Recognizing, however, that some agriculture-related business activities ("agribusiness") are not included in these other programs, a showing of ineligibility will qualify an agribusiness, such as feed lots, for SBIC assistance, unless the activity involves production which is eligible for support payments or production loans from the Department of Agriculture.¹⁴⁹

Since it is the stated policy of the SBIAct to "improve and stimulate the national economy,"¹⁵⁰ it follows that SBICs may not invest abroad. Recognizing, however, that a domestic concern may require financing of imports, or of its foreign operation, the regulations permit financing for these purposes, if the majority of the domestic concern's assets and activities remain in the United States.¹⁵¹ Thus, the interposition of a domestic conduit, *e.g.*, a straw corporation, will not make foreign investment possible.

The function of the SBIC program is "to stimulate and supplement

143. 13 C.F.R. § 107.813 (1974). *See also* p. 203 *infra* (discussing the purchase of portfolio securities of one licensee by another).

144. 13 C.F.R. § 120.2(d)(8) (1974).

145. *See* p. 188 & note 32 *supra*.

146. These activities comprise Major Group 65 of the STANDARD INDUSTRIAL CLASSIFICATION MANUAL, *supra* note 32.

147. 13 C.F.R. § 107.1001(c)(1) (1974). "Operative builders" are no longer listed under Major Group 65, therefore, no exception need be made for such enterprises. The principle that only active and continuous business operations are eligible for assistance applies generally. *Id.* § 107.1001(f); *cf. id.* § 120.2(d)(2).

148. *Id.* § 107.1001(c)(2) (defining "prompt and substantial improvement" as improvement within a year and in an amount of at least half of the financing).

149. *Id.* § 107.1001(h); *cf. id.* § 120.2(d)(9).

150. 15 U.S.C. § 661 (1970).

151. 13 C.F.R. § 107.1001(e) (1974).

the flow"¹⁵² of funds to meet the needs of small concerns; therefore, a SBIC may not remain inactive. To this end, the regulations require qualified management available to the public¹⁵³ at accessible offices during business hours,¹⁵⁴ and require a Licensee to justify its failure to maintain a stated minimum activity. The regulations erect a rebuttable presumption that a SBIC is inactive if it has not invested at least 25% of its idle funds during an 18-month period, if its idle funds, in turn, exceed 25% of its assets.¹⁵⁵

"Idle funds" are those funds of a SBIC "not reasonably needed for their current operations," *i.e.* neither invested in or committed to small concerns nor maintained as a petty cash fund. Such idle funds may only be invested in direct obligations, or obligations guaranteed by the United States, in savings accounts up to the amount insured by the Federal Savings and Loan Insurance Corporation,¹⁵⁶ or in certificates of bank deposits maturing within one year.¹⁵⁷ Investments of idle funds in any other securities, irrespective of their quality or yield, are prohibited.

A Licensee may not finance activities contrary to the public interest. These prohibited activities include monopolistic practices,¹⁵⁸ investments in "runaway industries" which result in the substantial increase of unemployment in any area of the country¹⁵⁹ and gambling.¹⁶⁰ This last prohibition, in line with changing attitudes, should be liberalized soon, since the SBA has already liberalized its own loan policy to permit loans to small concerns which derive no more than one-third of their annual gross income from the sale of state lottery tickets under a state license, or from gaming in states which permit it.¹⁶¹

To protect its creditor position, the SBA controls the compensation of officers, directors and employees earning in excess of \$10,000 per year.¹⁶²

While generally a Licensee may retain its investment in a concern which was small at the time of investment, but subsequently grew large, it may retain securities obtained in the merger of a portfolio concern into a large business only until it can recover its original investment plus

152. 15 U.S.C. § 661 (1970).

153. 13 C.F.R. § 107.101(a) (1974).

154. *Id.* § 107.101(b).

155. *Id.* § 107.1003.

156. 15 U.S.C. § 687(b) (1970).

157. 13 C.F.R. § 107.808 (1974).

158. The SBA mission to preserve and expand competition in the American economic system of private enterprise is carried over into the Small Business Investment Act by § 308(f) thereof. 15 U.S.C. §§ 631, 687(f) (1970). *But see* 15 U.S.C. § 684(b) (1970); 13 C.F.R. § 107.304 (1974) (a licensee providing equity capital to a small concern may require that it have no other creditors).

159. 15 U.S.C. § 661 (1970).

160. 13 C.F.R. § 107.1001(d) (1974).

161. *Id.* § 120.2(d)(5).

162. *Id.* §§ 107.203(b)(3)(iii), 107.205(b). *See also id.* § 107.805(b)(2) (stock options not considered compensation).

a reasonable return thereon, and thereafter only so long as the holding does not interfere with new investments. It may make additional investment in a concern which has outgrown the SBA's size standard only pursuant to a commitment made while the portfolio concern was eligible, or to protect its investment in the formerly small concern.¹⁶³

While a SBIC may not usually purchase small business securities from anyone but the issuer,¹⁶⁴ the regulations recognize that one SBIC may have a surplus of idle funds, while another SBIC finds itself short of cash. In such circumstances, one SBIC may acquire the portfolio securities of another, but such purchases may not exceed one-third of the purchaser's total assets. If the seller guarantees debt securities, such guaranty may not exceed 90% of the amount outstanding at the time of default.¹⁶⁵ Where the selling Licensee retains a part of its investment in a portfolio concern, selling the other, or makes new investments in a portfolio concern for which it has extended a guaranty in connection with a sale to another Licensee, the liability under the guaranty must be included in the seller's "overline limit" under Sec. 306(a) of the Act.¹⁶⁶

Licensees are required to dispose of assets acquired in liquidation of portfolio items within a reasonable time in order to maintain their liquidity. A SBIC may spend funds for the preservation of such assets, but the sum of such expenditures, added to the original investment, may exceed the overline limit only with the SBA's approval.¹⁶⁷

Without the SBA's approval, a SBIC may neither transfer its license to another company,¹⁶⁸ nor surrender it to the SBA,¹⁶⁹ nor voluntarily reduce its capital (whether by distribution or by purchase of its own stock),¹⁷⁰ nor merge or consolidate with another concern, nor reorganize its capital structure.¹⁷¹

The SBA is authorized to suspend or revoke, by formal administrative proceeding, the license of a SBIC which has made a false or misleading written statement to the SBA,¹⁷² or which has wilfully and repeatedly violated provisions of the Act, the regulations, or a cease-and-desist order issued under this section. Since most SBICs have obtained leverage from the SBA, or with its guaranty, a license revocation would not serve the SBA's entire purpose, which includes repayment of the leverage. Thus, following license revocation, where a SBIC

163. *Id.* § 107.806.

164. See 15 U.S.C. §§ 684(a) (Supp. II, 1972), 685(a) (1970). *But see* 13 C.F.R. § 107.812 (1974).

165. 13 C.F.R. § 107.501 (1974).

166. *Id.* § 107.807. See also p. 195 *supra*.

167. *Id.* § 107.810.

168. *Id.* § 107.104.

169. *Id.* § 107.105.

170. *Id.* § 107.902.

171. *Id.* § 107.903.

172. 15 U.S.C. § 687a (1970). See also *id.* § 645 (1970); 18 U.S.C. §§ 1001, 1006 (1970).

does not repay voluntarily, the SBA would have to apply to a federal court for a money judgment, based on Sec. 308(d), which also provides for license revocation. In most cases, it is, therefore, more expeditious for the SBA to apply to a court in the first place. In order to simplify the court proceeding, which focuses on regulatory violation,¹⁷⁴ the SBA has declared that false or misleading statements to the SBA,¹⁷⁵ as well as default under a contract with the SBA,¹⁷⁶ is a violation of the regulations. This provision enables the SBA to sue on a false or misleading statement, and to ask for a money judgment, in the same proceeding. The SBA's enforcement is further facilitated by its statutory right to ask for a receivership, and to be itself appointed receiver in the court's discretion.¹⁷⁷

HOUSEKEEPING RULES

The regulations require a plan to safeguard the Licensee's assets, which includes "dual control", i.e. two signatures for the withdrawal of assets from custody, or the disbursement of funds, except disbursements up to \$1,000.¹⁷⁸ In addition, it must maintain fidelity insurance of at least \$25,000 for employees with access to its assets.¹⁷⁹

Books must be currently maintained in accordance with the SBA's System of Account Classifications.¹⁸⁰ Records are kept for the SBA's annual inspection,¹⁸¹ for which the SBA charges a fee based on the SBIC's assets, with additional charges levied where the examination is delayed due to some fault of the SBIC.¹⁸² The regulations prescribe detailed requirements for record maintenance and preservation.¹⁸³

In addition to the special reports mentioned above *passim* whenever the SBA's approval was mentioned, the SBA requires annual financial reports, and sometimes special interim reports on an *ad hoc* basis.¹⁸⁴ The annual (year-end) reports are required to be certified by an independent certified public accountant according to an Audit Guide published by the SBA for that purpose.¹⁸⁵ In addition, litigation, other than simple enforcement actions, must be promptly reported to the

173. 15 U.S.C. §§ 687c, h (1970) (conferring jurisdiction on federal courts, providing for long-arm jurisdiction, and requiring the federal court to expedite such cases in every way).

174. *Id.* § 687c(a).

175. 13 C.F.R. § 107.1008(b) (1974).

176. *Id.* § 107.1008(a).

177. 15 U.S.C. §§ 687c(b)-(c) (1970).

178. 13 C.F.R. § 107.1103 (1974).

179. *Id.* § 107.1104.

180. *See* p. 185 & note 15 *supra*.

181. 15 U.S.C. § 687(b) (1970).

182. 13 C.F.R. § 107.1101 (1970).

183. *Id.* § 107.1102(a)-(b). *See also* 17 C.F.R. § 270.31a-2(f) (1973) (preservation of records by registered companies under the Investment Company Act of 1940).

184. 13 C.F.R. § 107.1102(e)(1) (1974).

185. *Id.* § 107.1102(e)(2), (g).

SBA.¹⁸⁶ Reports must be filed in timely fashion, and a civil penalty of up to \$100 for each day of failure may be imposed¹⁸⁷ unless the SBA excuses such failure on the basis of an application filed before the due date of the report involved.¹⁸⁸

DUAL REGULATION SBA-SEC

In addition to the SBA regulation, a SBIC may be subject to the Securities and Exchange Commission's ("SEC") regulation under the Investment Company Act of 1940 ("1940 Act").¹⁸⁹ For example, when a SBIC makes a public offering of its securities or when it has more than 100 securities holders.¹⁹⁰ A discussion of SEC regulations is beyond the scope of this article.¹⁹¹ It should be noted that, by joint effort of the SEC and the SBA, the burden of dual regulation has been considerably reduced.¹⁹² For example, since conflict-of-interest transactions are regulated by the SEC, a 1940 Act company which has received an exemption for such a transaction, need not apply for an exemption from the SBA.¹⁹³ Also, since the 1940 Act requires the SEC

186. *Id.* § 107.1102(f).

187. 15 U.S.C. § 687g (1970).

188. 13 C.F.R. § 107.1203 (1974).

189. 15 U.S.C. § 80a-1 *et seq.* (1970).

190. An exemption from SEC Regulation under the Investment Company Act of 1940 is provided for SBA-guaranteed debt securities which are publically offered, or held by not more than one hundred persons.

The term "public offering" as used in section 3(c)(1) of the Act shall not be deemed to include the offer and sale by a small business investment company, licensed under the Small Business Investment Act of 1958, of any debt security issued by it which is (a) not convertible into, exchangeable for, or accompanied by any equity security, and (b) guaranteed as to timely payment of principal and interest by the Small Business Administration and backed by the full faith and credit of the United States. The holders of any securities offered and sold as described in this section shall be counted, in the aggregate, as one person for purposes of section 3(c)(1) of the Act.

17 C.F.R. § 270.3c-3 (1973).

Notwithstanding subsection-(a) of this section, none of the following persons is an investment company within the meaning of this subchapter:

(1) Any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.

15 U.S.C. § 80a-3(c)(1) (1970).

191. See generally Mendelssohn & Cerino, *Applications of the Federal Securities Laws to Minority Enterprise Small Business Investment Companies*, 16 How. L. J. 744 (1971). The title notwithstanding, the article discusses SBIC's without limitation to § 301(d) Licensees (formerly called MESBICS). It was written before adoption of the SBA's program for minority enterprise investment companies which were then an integral part of the investment company program. See note 9 *supra*.

192. See generally 15 U.S.C. §§ 687(g)(2)(H),(J) (1970) (requiring the SBA to include in its annual report to the President and the Congress a statement from the SEC enumerating the actions taken by the latter agency to simplify and minimize the requirements of dual regulation).

193. 13 C.F.R. § 107.1004(g) (1974). See also *id.* § 107.1004(e) (imposing a publication requirement). But see S. 2628, 93d Cong., 1st Sess. (1973); S. 2629, 93d Cong., 1st Sess. (1973).

regulation of stock options but the SBIAct does not, 1940 Act companies must comply with the SBA's stock options rule for 1940 Act companies,¹⁹⁴ but other SBICs need not.¹⁹⁵ The SBA and the SEC have cooperated also with respect to financial reports,¹⁹⁶ and the SBA calls the requirements of the 1940 Act to the attention of SBICs, when appropriate.¹⁹⁷

CONCLUSION

While the foregoing discussion cannot be considered an exhaustive description of the regulatory system governing SBICs,¹⁹⁸ it is hoped that the present article affords a bird's-eye view and may encourage greater utilization of this relatively new and quite flexible venture capital medium for small business.

194. *Id.* § 107.805(b)(1) (adopted in cooperation with the SEC).

195. *Id.* § 107.805(b)(3).

196. *Id.* § 107.1102(d).

197. *E.g.*, 38 Fed. Reg. 30844 n.9 (1973).

198. No reference has been made to the various benefits which the Internal Revenue Code confers. INT. REV. CODE OF 1954, §§ 172(b)(1)(F), 243(a), 542(c)(8), 582(e), 586, 1242-43; Treas. Reg. § 1.1242-1(a) (1960). Also omitted are the Policy and Procedures Releases which the SBA issues from time to time to explain its practices and assist SBICs in their compliance with the regulations.